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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1963

HENDERSON CLAY PRODUCTS, *Petitioner*

vs.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Henderson Clay Products prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, insofar as the same reverses the judgment of the United States District Court for the Eastern District of Texas.

OPINIONS BELOW

The opinion of the Circuit Court is to be found in 324 F. 2d 7, and the opinion of the District Court in 199 F. Supp. 304. Such opinions appear in the appendix hereto.

JURISDICTIONAL GROUNDS

The judgment of the Court of Appeals was entered on October 25, 1963; a petition for rehearing was

timely filed and considered and denied by order entered on December 30, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254, Act of June 25, 1948, c. 646, 62 Stat. 928, 28 U.S.C.A. Sec. 1254.

QUESTIONS PRESENTED

This is an income tax case involving the percentage depletion deduction. Petitioner, an integrated miner-manufacturer, mines ball clay and makes brick therefrom in East Texas; it sells no raw ball clay and none is sold in its area other than by miners located in Kentucky and Tennessee; the mining and selling of raw ball clay is a major industry in Kentucky and Tennessee; such Kentucky-Tennessee miners sell the raw ball clay all over the United States, and the District Court found (and the Circuit Court approved) that Petitioner's clay was of a "like kind and grade" as to the Kentucky-Tennessee ball clay; the District Court held under *Cannelton* that Petitioner's "gross income from mining", in computing its percentage depletion income tax allowances for fiscal 1951-1954, was to be determined by reference to the regular prices received by such miners for ball clay of a like kind and grade—that is, "gross income from mining" was the value of Petitioner's raw mineral in its first marketable state. The Circuit Court reversed, holding that Petitioner's gross income from mining must be determined by the proportionate profits method—that is, the costs of extraction and the other processes considered to be mining were determined, and total costs of extraction, mining, and manufacturing were deter-

mined, and gross income from mining was held to be a percentage of the sales price of the finished brick in the proportion that mining costs bore to total costs.

The questions presented are:

1. Whether, in so holding, the Court of Appeals departed from the decisions of this Court in *United States v. Cannelton Sewer Pipe Company*, 364 U.S. 76, and *Riddell v. Monolith Portland Cement Company*, 371 U.S. 537.

2. Whether the holding of the Court of Appeals conflicts with *Hugoton Production Company v. United States*, 315 F. 2d 868 (Ct. Cl., 1963), and *Alabama By-Products Corporation v. Patterson*, 258 F. 2d 892, (C.A. 5, 1958), certiorari denied 358 U.S. 930.

3. Whether, in deciding a factual issue, voluntarily raised by the Court of Appeals, and not tendered to or decided by the District Court, the Court of Appeals departed from the decisions of this Court in *Byrd v. Blue Ridge Rural Electric Co-operative*, 356 U.S. 525, and similar cases. That factual issue was, whether the prices regularly received by ordinary miners of a certain mineral are "representative" in the case of an integrated miner-manufacturer of a mineral of like kind and grade.

STATUTES AND REGULATIONS INVOLVED

These are rather voluminous and are set forth in the Appendix, *infra*, pages 25 to 29.

As here pertinent, the Internal Revenue Code of

1939 (26 U.S.C. Sec. 23), Sec. 114(b)(4), dealing with percentage depletion for coal and metal mines and for certain other mines and natural deposits, reads:

"(A) In general.—The allowance for depletion under section 23(m) in the case of the following mines and other natural deposits shall be—

* * * *

"(iii) in the case of . . . ball clay . . . 15 per centum . . . —

* * *

of the gross income from the property during the taxable year. . . .

"(B) . . . Gross Income from Property. As used in this paragraph the term 'gross income from the property' means the gross income from mining. The term 'mining' as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground, but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products. . . ."

Treasury Regulations 118 (1939 Code):

"Sec. 329.23(m)-1 *Depletion mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*— . . .

* * * *

"(e) As used in sections 114(b)(3) and 114(b)(4)(A) . . . the term 'gross income from the property' means the following: . . .

* * *

"(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, 'gross income from the property' means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, 'gross income from the property' means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes."

STATEMENT

The material facts as found by the District Court (R. 101 to 122) and concurred in by the Court of Appeals (R. 568 to 594) may be summarized as follows:

Petitioner is an integrated miner-manufacturer, owning ball clay pits near Henderson, Texas, engaged in the business of mining such clay and manufacturing and selling brick all over the United States. (R. 113). Petitioner has never sold any clay as raw or

partially processed clay. All of its mined clay was made into face brick and sold as brick. (R. 168). During the fiscal years 1951 through 1954, Petitioner mined and sold in the form of brick 53,540.2 tons in 1951, 51,755.9 tons in 1952, 53,699.3 tons in 1953, and 55,387.7 tons in 1954. (R. 169-170).

Upon examining Petitioner's returns for fiscal 1951-1954, the Internal Revenue Agent found that its clay was ball clay, entitled under IRS Section 114(b)(1)(A) to a depletion rate of 15% of the gross income from the property, but that such "gross income from the property", under Regulations 118, Sec. 329.23(m)-1, was a theoretical gross income or proportion of the sales price of the finished brick equal to the per cent thereof which the costs of extraction and processes up to the pug mill bore to the total costs involved in mining, processing and completing the finished brick. (Ex. 10; R. 186). Such findings resulted in deficiencies in income tax, which Petitioner paid; it then filed claims for refund. (Ex. 2, 3, 4 and 5; R. 190). When such claims were rejected, Petitioner filed suit in the Eastern District of Texas for refunds, invoking the jurisdiction of that Court under 28 U.S.C. Sec. 1346(a)(1), Act of June 25, 1948, c. 646, 62 Stat. 689, as amended.

Approximately 90% of the ball clay produced in the United States is mined by non-integrated miners in four or five counties in the Kentucky-Tennessee area. (R. 114). Ball clay is not sold as it comes from the earth in the absolutely raw state (R. 230), but is processed by such miners into the disintegrated or

shredded form, and, with further processing, into the pulverized or air-floated form. (R. 176, 360). Petitioner's mining processes were essentially identical to those of the Kentucky-Tennessee miners up to and through the shredded clay stage (R. 366), and the District Court so held. (R. 114-117).

During the tax years, ball clay was sold by the Kentucky-Tennessee miners all over the United States (R. 223, 251) in approximately equal amounts of shredded and air-floated ball clay. (R. 364). The average prices paid to such miners for shredded ball clay was $10.50 per ton (R. 236, 264), and there was no dispute among the witnesses on this point. Texas manufacturers of ceramic products bought from 9,900 tons in 1951, to 13,600 tons in 1954, of shredded ball clay from such Kentucky-Tennessee miners and paid therefor an average of $10.50 per ton. (R. 352, 357). The price per ton which Petitioner received for its finished bricks averaged approximately $8.75 per ton for the 1951-1954 period.

The District Court found that Petitioner's shredded clay was of a grade and kind like the Kentucky-Tennessee shredded ball clay (R. 115), and the Circuit Court approved. (R. 574).

The District Court found and concluded (R. 114-115)—

> "During the tax years in question there was a market for shredded ball clay and air-floated clay all over the United States, and the average market value of shredded ball clay during each of those years was the sum of $10.50 per ton. There-

fore I find that the first commercially marketable product obtained from ball clay is shredded ball clay, and that the processes applied by the miners of ball clay in the Tennessee-Kentucky area to obtain said shredded ball clay are those that must be normally applied by mine owners or operators in order to obtain shredded ball clay. The processes used by Plaintiff in mining and handling its ball clay up to the time said clay is put in its pug mill are substantially the same as the processes applied by ball clay miners in the Tennessee-Kentucky area in obtaining shredded ball clay. Plaintiff's ball clay in the condition it was in at the time it was put in Plaintiff's pug mill was the same or substantially the same as the shredded ball clay marketed by the ball clay miners in the Tennessee-Kentucky area. Thus I find and conclude that the first commercially marketable product Plaintiff obtained in the mining of its ball clay was its clay in the condition it was in at the time it was ready to be placed in Plaintiff's pug mill, i. e., shredded ball clay, and that the processes used by Plaintiff in obtaining said shredded ball clay were the ordinary treatment processes normally applied by owners or operators of ball clay mines in order to obtain shredded ball clay. I further find that during each of the years in question Plaintiff's ball clay in the condition it was in at the time it was placed in Plaintiff's pug mill had an average market value or value of $10.50 per ton."

and—

"However, under such findings and the teachings of *Cannelton*, Plaintiff's depletion base or gross income from its property during each of the tax years in question was the product of the number

> of tons of ball clay mined and processed by Plaintiff during the tax year times the value per ton ($10.50) of said clay at the stage it was ready to be placed in Plaintiff's pug mill."

The Court of Appeals agreed with all of the foregoing, except the final holding that Petitioner's gross income from mining was the product of the number of tons of the ball clay it mined, times $10.50. On this point, the Court of Appeals determined factually that the $10.50 per ton received by the ordinary miners for shredded ball clay was not, under the foregoing regulations, the "representative market or field price" for Petitioner's ball clay, because (1) using the regular miners' prices in the computation of the depletion base produced a "gross income from the property" in excess of Petitioner's actual gross income from its mining property; (2) the price received by an ordinary miner for his mineral is not the "representative market or field price" for a miner-manufacturer, even though both minerals are of a like kind and grade, if the miner and the miner-manufacturer are not in competition; and Petitioner did not compete with the Kentucky-Tennessee miners (although the record is devoid of testimony on this point); and (3) "*Cannelton* requires the computation of a hypothetical gross income for an integrated miner-manufacturer, but it does not require the computation of *this* kind of income" (R. 582), apparently referring to the prices received by ordinary miners; and (4) finally, that the proportionate profits method of determining gross income from the property, although yielding an equally hypothetical result, comes closer to Petitioner's

purely mining activities than the ordinary miners' market prices. (R. 588). In brief, the Court of Appeals held that the "gross income from the property" was neither the value of the raw mineral in its first marketable state, nor the sales price of the finished brick (the actual gross income).

REASONS FOR GRANTING THE WRIT

1. In *United States v. Cannelton Sewer Pipe Company* (1960), 364 U.S. 76, the issue was whether, under the statute and regulations, the first commercially marketable mineral product of an integrated miner-manufacturer of sewer pipe and related clay products was the first product it could sell profitably—sewer pipe—or the partially processed clay, referred to as raw clay, regularly sold by ordinary miners. If the sales price of the finished product was used in determining the miner-manufacturer's percentage depletion deduction, its gross income from the property was approximately $40.00 per ton and the depletion allowance $4.00 per ton, whereas the ordinary clay, as sold by ordinary miners, brought $1.60 to $1.90 per ton, and the depletion allowance based on the sales price of such clay was approximately 20 cents per ton. This Court held that Congress intended to grant miners, including miner-manufacturers, a depletion allowance based on the "constructive income from the raw mineral product" if marketable in that form, and not on the value of the finished article; that for depletion purposes, a taxpayer's inability to sell its mineral profitably in any form prior to the finished product was immaterial if there existed in fact a com-

mercial market for the raw mineral; that "gross income from mining" stops where the ordinary miner sells and ships his mineral; that all processes used by ordinary miners before shipment are available to the integrated miner-manufacturer under the statutory definition of mining, and that his "gross income from mining" is to be determined at the point where ordinary miners dispose of their product.

In *Riddell, Director, v. Monolith Portland Cement Company* (1963), 371 U.S. 537, the taxpayer mined limestone, crushed and transported it, and manufactured it into cement; the taxpayer claimed that its first commercially marketable mineral product was cement, and that its "gross income from mining" was the sales price of such cement. The Circuit Court noted (301 F. 2d 488, at 490 and 494) that there was no local market for crushed cement rock; but it also appeared that limestone is regularly sold in the United States in the form of crushed limestone. This Court, noting that *Cannelton* requires that the "statutory percentage depletion allowance on the gross income of an integrated mining operator should be cut off at the point where the mineral first became suitable for industrial use or consumption", held that the integrated taxpayer's basis for depletion was its constructive income from crushed limestone. Upon remand, *Monolith Portland Cement Company v. Riddell*, (U.S.D.C. Calif. 1963), 12 A.F.T.R. 2d 5087, the District Court found that—

> "Over 216,000,000 tons of limestone with an average value of $1.36 per ton were sold or used

by producers in crushed or broken form in the United States in 1952."

and concluded that—

> "The taxpayer's limestone was marketable when it reached the crushed limestone stage. The mining of the limestone terminated at that point. The taxpayer's percentage depletion base is its constructive income from crushed limestone, rather than its gross income from sales of cement. . . ."

Thus, this Court has been explicit in its view that if a market exists for the raw mineral product, the integrated miner-manufacturer's gross income from mining must be determined by reference to such market. In fact, the Court of Appeals below in this case (R. 578) states,

> "Certainly, *Cannelton* seems to hold that an integrated miner-manufacturer *must* use as his depletable base a hypothetical gross income based on the market price of the mineral sold by the ordinary miner. And, on principle, it is irrelevant whether, in a particular case, the *Cannelton* rule will give a higher base or a lower base than the gross income from the finished product will yield."

Nevertheless, the Court of Appeals refused to permit this taxpayer to do exactly what this Court in *Cannelton* specifically states is the proper thing to do (364 U.S. 76, at 89):

> "It would, of course, be permissible for such an operator to calculate his 'gross income from mining' at the point where 'ordinary' miners—not

integrated—disposed of their product. All processes used by the nonintegrated miner before shipping the raw fire clay and shale would under such formula be available to the integrated miner-manufacturer to the same extent but no more."

Instead, the Court of Appeals required that this taxpayer use as its gross income from mining a wholly hypothetical figure—a proportion of the sales price of its brick which the costs of processing up to the pug mill bore to the total costs of producing the brick; that is, if the costs of digging, transporting, shredding, grinding, shaping, drying and burning, per ton, is, for example, $5.00, and the costs of the first four processes are 50 cents per ton, then 10% of the sales price of the brick is the gross income from mining. If this action of the Court of Appeals is the law, and if the reasons it gave for refusing to permit the determination of this taxpayer's "gross income from mining" by reference to the ordinary miners' ball-clay prices for a clay of like kind and grade, are permitted to stand, then it is submitted that there is little left of *Cannelton* and *Monolith*. In refusing to hold that "gross income from mining" is the value of the raw mineral in its first marketable state, the Lower Court erred, for the following reasons:

First. The Circuit Court wholly misinterpreted the regulations. It held that before an integrated miner-manufacturer can use as the gross income from mining the sales prices received by ordinary miners for the raw mineral, such prices must be "representative" of such taxpayer's mineral. (R. 584).

Actually, of course, "representative," as used in the regulations, relates only to the ordinary miners' prices; that is, out of all of the prices charged by ordinary miners, a "representative market or field price" must be used. Regulations 329.23(m)-1(e)(3) provides that if the taxpayer does not sell the crude mineral product, but processes it beyond the ordinary processes used by miners, then the

> " 'gross income from the property' means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes. . . ."

In brief, as Petitioner did not sell raw clay, this regulation says Petitioner must use in determining its gross income from the property a price which is representative of the market prices received by miners of the same kind and grade of clay.

Second. The Court of Appeals says in substance that *Cannelton* and the first sentence of the foregoing regulations do not apply if the "gross income from mining", determined by reference to the representative prices received for raw clay by miners, exceeds the taxpayer's actual income from the property.

It may be that the taxpayer's "gross income from the property" for depletion purposes should be *limited* to its actual gross income from the property; after all, the words of the statute *are* "gross income from the property." But there is no law or regulation or pronouncement of this Court to that effect, and as the Circuit Court candidly admitted (R. 578)—

> ". . . on principle, it is irrelevant whether, in a particular case, the *Cannelton* rule will give a higher base or a lower base than the gross income from the finished product will yield."

But, whatever may be the correct rule as to limiting a taxpayer to its actual gross income from the property, the foregoing reason given by the Court of Appeals is not a valid reason for requiring a taxpayer to use a wholly hypothetical figure determined by the proportionate profits method. Quite frequently, the depletion base, determined under the proportionate profits method, exceeds the base determined by reference to the ordinary miners' market prices. See *Alabama By-Products Corporation v. Patterson*, 258 F. 2d 892 (C. A. 5, 1958), *infra*.

Third. The Court of Appeals says that, in order for the ordinary miners' market prices to be used in the determination of the "gross income from mining" of an integrated miner-manufacturer, the ordinary miner and the miner-manufacturer must be in competition. The Court of Appeals says (R. 586)—

> "The representative price is then the competitive going price for the product, i. e., the price charged by the taxpayer's competitors."

If this is correct, then there is little left of *Cannelton*. So far as appears, the taxpayer in *Cannelton* did not compete with the ordinary miners; *Monolith Portland Cement Company* neither bought nor sold crushed limestone, and it in nowise competed with the ordinary miners who sold 216,000,000 tons of crushed limestone in the United States in the tax years in-

volved in that case. In fact, in the numerous Court of Appeals and District Court cases involving the percentage depletion allowance for clay, limestone, shale, etc., we have found very few in which competition was possible. The statute says in substance that the sales price of the first commercially marketable mineral product is the gross income from mining; neither it nor the regulations, nor *Cannelton* nor *Monolith* mention competition as a factor in the determination of that gross income from mining.

The statute says that "mining" as used in "gross income from mining" means extraction and the ordinary treatment processes necessary to obtain the "commercially marketable mineral product." This means, as this Court held in *Cannelton*, that the integrated miner-manufacturer who does not sell the raw mineral must use the value of the first commercially marketable mineral product in determining his "gross income from mining." This clear and definite criteria, springing from the specific terms of the statute, should not be undermined and eroded by extraneous, litigation-breeding factors, such as whether the manufacturer competed with the miner, etc.

2. The holding of the Court of Appeals in this case (that the average sales prices received by Kentucky-Tennessee ordinary miners for a mineral of a kind and grade like taxpayer's minerals cannot be used in the determination of the taxpayer's gross income from mining) directly conflicts with *Hugoton Production Company v. United States*, 315 F. 2d 868 (Court of

Claims, 1963), and *Alabama By-Products*, 258 F. 2d 892 (C. A. 5, 1958), certiorari denied 358 U.S. 930.

Hugoton involved the determination of the "gross income from the property" of a producer-processer, who produced and processed raw gas into refined products, which it sold. Mr. Justice Reed (Ret.), sitting by designation, delivered the opinion of the Court:

> "In this action plaintiff contends that gross income for depletion purposes should be computed by multiplying the quantity of gas which it processed and sold in each year by an amount determined to be the representative market or field price for its gas at the wellhead (less royalty payments). The Government, on the other hand, contends that there was no representative price for plaintiff's gas during the tax years in issue, and therefore that gross income from the property should be calculated by taking the gross proceeds from the sale of plaintiff's processed gas and its by-products and subtracting therefrom all costs attributable to gathering and processing the gas, a 10% return on the capital invested in these nonproducing functions and all royalty payments. Following the terminology in Woodward Iron Co. v. Patterson, 173 F.Supp. 251, 268 (N.D.Ala. 1959), we may refer to the method of computation now urged by the plaintiff as a 'market comparison' method, and to that urged by the Government as a 'proportionate profits' method.
>
> "Hence, we must first determine which of these two methods is to be used. Since we conclude that the regulation requires use of a market comparison method in this case, we reach a perhaps more

difficult question."

* * *

"The regulations provide that gross income from the property shall be assumed the equivalent of the representative market or field price at the wellhead so that, if there is such a price, it must govern here. The Government does not contend that its proportionate profits formula yields such a representative price, but argues only that there is no such price, so that its alternative method may be utilized."

The Court of Claims went on to say that with respect to "representative market or field price"—

"'. . . the test is what do . . . [purchasers] pay for gas similar in quantity, quality, and availability to market?' Phillips Petroleum Co. v. Bynum, 155 F.2d 196, 198, 199 (C. A. 5), cert. denied, 329 U.S. 714, 67 S.Ct. 44, 91 L.Ed. 620 (1946). If evidence of substantially comparable sales can be shown, however, the price so derived is not to be disregarded merely because it is an approximation."

* * *

"We are seeking the 'constructive income' from the raw gas at the wellhead. Cf. United States v. Cannelton Sewer Pipe Co., 364 U.S. at 86; 80 S.Ct. at 1586-1587, 4 L.Ed. 2d 1581. We want to know the price for which the taxpayer would have sold its gas at the wellhead in each tax year in issue had its operations terminated at that point. The taxpayer argues that for this purpose we must take the price which it could have obtained under a long-term contract entered in each tax year in question."

The Government argued in *Hugoton* that the raw gas sales price should be determined by reference to all existing long-term contracts, those made in each tax year, as well as those made previously. The Court of Claims held that a weighted average of the raw gas prices determined by reference to all contracts in existence during the tax years was the representative sales price of raw gas. Thus, the Court held that the integrated producer-processer of raw gas must use the constructive income from raw gas—that is, the price for which the taxpayer could have sold its gas as it came from the wellhead, and that this price was to be determined by reference to sales of raw gas at the wellhead.

Here, there is no conflict in the evidence that $10.50 per ton was the representative or average market price received by Kentucky-Tennessee miners for shredded ball clay; and the testimony was that this Petitioner could have sold its ball clay as shredded ball clay for $10.50 per ton, (R. 364, 368, 369, 398).

We are unable to find any distinctions of merit between the present case and *Alabama By-Products v. Patterson*, 258 F. 2d 892 (C.A. 5, 1958), cert. denied 358 U.S. 930, except that there the taxpayer wanted to use the proportionate profits method of determining gross income from the property. Both *Alabama By-Products* and Petitioner were integrated miner- manufacturers; both processed their minerals beyond ordinary treatment processes; *Alabama By-Products* sold a small amount of its raw mineral to others, but this was held to be negligible and immaterial. In both

cases, there were substantial sales of the raw material by the ordinary miner. *Alabama By-Products* urged that the coking coal which was sold by the ordinary miners in the raw state did not have the same attributes and characteristics as its coking coal; that such other coals would not produce the coke that its customers demanded, and that the two coking coals were not of like kind and grade and, therefore, the prices paid for the other coking coals were not representative.

The Court of Appeals, holding that if two minerals are of like kind and grade, the market price of one is the representative market price of the other, stated:

> "We cannot assume that it was intended that the use to which the property was actually put should be decisive in classifying mineral products for purposes of the representative market price and proportionate profits methods of computing the gross income from mining."
>
> * * *
>
> "The sales and purchases of coking coal by De-Bardeleben, Republic, United States Steel, United States Pipe and Foundry and others were extensive enough to establish a representative market price."
>
> * * *
>
> "We agree, therefore, with the district court that 'like kind and grade' means as to 'kind', all bituminous coals mined in the Birmingham area, and, as to 'grade', means all coals having coking quality suitable for commercial use. Since the taxpayer's coals are of like kind and grade to other coking coals that were sold in the area, the

taxpayer has failed to meet its burden of proving that there was no representative market or field price for its coals."

In brief, in both *Hugoton* and *Alabama By-Products* it was determined that the "gross income from the property" for depletion purposes of an integrated producer-processer who sold no raw gas or raw mineral, was to be determined by reference to the prices which were representative of the prices received from sales of the raw gas or the raw mineral of a like kind and grade, and that the proportionate profits method could not be used. The Court of Appeals in the present case, although definitely holding that Petitioner's ball clay was of the same kind and grade as that of the ordinary miners, and that such raw ball clay was sold all over the United States, including Texas, nevertheless rejected such raw clay prices and required the use of the proportionate profits method. It follows that there is a definite conflict between these cases.

3. The Court of Appeals failed to follow *Byrd v. Blue Ridge Rural Electric Co-operative*, 356 U.S. 525 (1958), and similar cases.

Alabama By-Products, along with *Shamrock Oil & Gas Corporation*, 35 T.C. 979, at 1028-1040, clearly holds that whether a representative market price exists, and what that price is, are fact questions.

In the trial of this case in the District Court, it was tacitly assumed by the Court and both parties that if Petitioner's clay and the Kentucky-Tennessee ordinary miners' clay were of like kind and grade,

the representative or average prices received by such miners for such clay were the "representative market or field price" as used in the regulations, and that such price, times the number of tons of clay Petitioner mined, was its "gross income from mining." Consequently, the battle in the District Court related to whether the two clays were of like kind and grade. The District Court held affirmatively, and the Court of Appeals found no error in this holding.

However, the Court of Appeals, when it came to deciding the appeal, raised the factual issue of whether, notwithstanding like kind and grade, the Kentucky-Tennessee prices were the representative market prices for Petitioner's mineral; and then, without permitting any opportunity to the parties to offer evidence, decided that issue against Petitioner.

In *Byrd v. Blue Ridge Rural Electric Co-operative, supra*, Petitioner, an employee, sued his employer for damages for negligence causing him personal injury; the employer contended that under the State Compensation Act the Petitioner must accept statutory compensation benefits, rather than a tort judgment, because the employer was a "statutory employer". The Trial Court interpreted the state statute in such a way that Petitioner had no occasion to put on evidence bearing on its applicability to the case. On appeal, the Court of Appeals disagreed with the District Court's construction of the state statute, and held that if certain facts were true, then the state statute granted the Respondent immunity from the tort action. It then determined such facts and, on the basis thereof, re-

versed the District Court. This Court granted certiorari and held:

> "However, instead of ordering a new trial at which the petitioner might offer his own proof pertinent to a determination according to the correct interpretation, the Court of Appeals made its own determination on the record and directed a judgment for the respondent."
>
> * * *
>
> "While the matter is not adverted to in the court's opinion, implicit in the direction of verdict is the holding that the petitioner, although having no occasion to do so under the District Court's erroneous construction of the statute, was not entitled to an opportunity to meet the respondent's case under the correct interpretation. That holding is also implied in the court's denial, without opinion, of petitioner's motion for a rehearing. . . ."
>
> * * *
>
> "We believe that the Court of Appeals erred."
>
> * * *
>
> "At all events, the petitioner is plainly entitled to have an opportunity to try the issue under the Court of Appeals' interpretation."
>
> * * *
>
> "He thus cannot be penalized by the denial of his day in court to try the issue under the correct interpretation of the statute. Cf. Fountain v. Filson, 336 U.S. 681, 69 S.Ct. 754, 93 L.Ed. 971; Weade v. Dichmann, Wright & Pugh, Inc., 337 U.S. 801, 69 S.Ct. 1326, 93 L.Ed. 1704; Globe Liquor Co. v. Sam Roman, 332 U.S. 571, 68 S.Ct. 246, 92 L.Ed. 177; Cone v. West Virginia Pulp

& Paper Co., 330 U.S. 212, 67 S.Ct. 752, 91 L.Ed. 849."

Thus, in deciding the factual issue relating to representative market price, and reversing on the basis of that determination, the Court of Appeals in this case departed from the law as set forth in *Byrd v. Blue Ridge Rural Electric Co-operative, supra*, and the cases cited therein.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

STATUTES AND REGULATIONS INVOLVED:

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.***

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * *

(b) *Basis for Depletion.*—

(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain

upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

(4) [as amended by Sec. 145(a), Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 124(a), Revenue Act of 1943, c. 63, 58 Stat. 21, and Sec. 319(a), Revenue Act of 1951, c. 521, 65 Stat. 452] *Percentage depletion for coal and metal mines and for certain other mines and natural deposits.*

(A) *In general.*—The allowance for depletion under section 23(m) in the case of the following mines and other natural deposits shall be—

(i) in the case of sand, gravel, slate, stone (including pumice and scoria), brick and tile clay, shale, oyster shell, clam shell, granite, marble, sodium chloride, and, if from brine wells, calcium chloride, magnesium chloride, and bromine, 5 per centum,

(ii) in the case of coal, asbestos, brusite, dolomite, magnesite, perlite, wollastonite, calcium carbonates, and magnesium carbonates, 10 per centum,

(iii) in the case of metal mines, aplite, bauxite, fluorspar, flake graphite, vermiculite, beryl, garnet, felspar, mica, talc (including pyrophilite), lepidolite, spodumene, barite, ball clay, sagger clay, china clay, phospate rock, rock asphalt, trona, bentonite, gilsonite, thermardite, borax, fuller's earth, tripoli, refractory and fire clay, quartzite, diatomaceous earth, metallurgical grade limestone, chemical grade limestone, and potash, 15 per centum, and

(iv) in the case of sulfur, 23 per centum, of the gross income from the property during the

taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(B) [as added by Sec. 124(c), Revenue Act of 1943, *supra*, amended by Sec. 207(a), Revenue Act of 1950, c. 994, 64 Stat. 906, and Sec. 304(d), Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137] *Definition of Gross Income from Property.*

As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining" as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which the ordinary treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills. The term "ordinary treatment processes," as used herein, shall include the following:***(iii) in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and minerals

which are customarily sold in the form of a crude mineral product — sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment;***. The principles of this subparagraph shall also be applicable in determining gross income attributable to mining for the purposes of sections 450 and 453.

(26 U.S.C. 1952 ed., Sec. 114.)

Treasury Regulations 118 (1939 Code):

Sec. 329.23(m)-1 *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—***

* * * * *

(e) As used in sections 114(b)(3) and 114(b)(4)(A) and §§ 39.23(m)-19, inclusive, the term "gross income from the property" means the following:

* * *

(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, "gross income from the property" means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, "gross income from the property" means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price

of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and proportionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes. If the taxpayer establishes to the satisfaction of the Commissioner that another method of computation, other than the computation of profits proportionate to costs, clearly reflects the gross income from the property, then such gross income shall be computed by the use of such other method.

* * *

OPINIONS BELOW:

Opinion of Court of Appeals (324 F. 2d 7):

IN THE
United States Court of Appeals
For the Fifth Circuit

No. 19471

UNITED STATES OF AMERICA, *Appellant*,
versus
HENDERSON CLAY PRODUCTS, *Appellee*.

Appeal from the United States District Court for the Eastern District of Texas.

(October 25, 1963.)

Before TUTTLE, Chief Judge, WISDOM, and GEWIN, Circuit Judges.

WISDOM, Circuit Judge: The problem this tax

case presents is one of defining "gross income from mining" in determining the depletion allowance for an integrated miner-manufacturer of ball clay processed into bricks. The chief difficulty arises from the fact that although the first commercially marketable product of non-integrated clay miners is shredded ball clay having a market price of $10.50 a ton, the taxpayer sold its finished brick for only $8.75 a ton.

Section 23(m) of the Internal Revenue Code of 1939, 26 U.S.C.A. §23(m), established a deduction of a "reasonable allowance for depletion" of mineral resources, such allowance "to be made under rules and regulations to be prescribed by the Commissioner". Section 114(b)(4)(A)(iii) of the International Revenue Code of 1939 provides for a depletion allowance for clay of 15 per cent "of the gross income from the property", such allowance not to exceed 50 per cent of the net income of the taxpayer from the property. Subsection (b) defines "gross income from the property" as "gross income from mining". Mining includes "not merely the extraction" but also "the ordinary treatment processes [and minimum transportation] normally applied ... to obtain a commercially marketable mineral product". Gross income is further defined in Section 39.23(m)-1(e)(3) of Treasury Regulations 118. This regulation provides that when the mined product is processed or transported beyond those minima described in Section 114(b)(4)(B), constructive gross income from the product is established by one of two methods. (1) The taxpayer takes the "*representative market or field price (as of the date*

of sale) of a mineral product of like kind or grade as beneficiated by the ordinary treatment processes actually applied, before transportation of such product", and multiplies that price by the tonnage of minerals actually mined. (2) Or, if there is no such representative price for the depletable mineral product, the *proportionate profits method* is used to determine a constructive income from the property. This is the proportion of the sales price of the final product equalling the percentage which the costs of mining and processing the mineral bear to the total cost of producing the finished goods.

Henderson Clay Products, the taxpayer, is an integrated manufacturer: its production process includes all functions from the extraction of ball clay mined from its own pits near Henderson, Texas, to the conversion of the clay into finished bricks which the company sells throughout the country. The clay is stripmined, by draglines or shovels, and hauled to the plant where it is crushed and shredded to manageable size, after which it is blended and ground to a uniform particle size. It is then transported to a pug mill where, mixed with water, the clay is formed into the shape of bricks, dried, burned in kilns, and shipped or stored for later shipment. None of it is sold in raw or semi-processed form. The per ton price for Henderson's finished brick averaged approximately $8.75 over this four year period.

For the fiscal years 1951-54, the taxpayer used the gross income from its finished brick as the basis for

its depletion allowance.[1] The Commissioner challenged these returns and assessed deficiencies based on the proportionate profits method for determining percentage depletion. Henderson paid the deficiencies and filed suit for refund, contending that since brick was its first commercially marketable product, its gross income from mining was its gross income from the brick. See, for example, *Cherokee Brick and Tile Co. v. United States*, 5 Cir. 1955, 218 F. 2d 424; *United States v. Merry Brothers Brick and Tile Co.*, 5 Cir. 1957, 242 F. 2d 708, *cert. den'd* 1957, 355 U.S. 824, 78 S. Ct. 31, 2 L. Ed. 2d 38.

During one of five continuances of the action,[2] the Supreme Court decided *United States v. Cannelton Sewer Pipe Co.*, 1960, 364 U.S. 76, 80 S. Ct. 1581, 4 L. Ed. 2d 1581. *Cannelton* holds that "ordinary treatment processes" are to be considered those applied by

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[1] During the fiscal years in question, the taxpayer mined 53,540.2 tons of clay in 1951; 51,735.0 tons in 1952; 53,699.3 tons in 1953; and 55,387.7 tons in 1954. Actual gross income from the sale of burnt brick was as follows: $468,694.11 in 1951; $465,668.33 in 1952, $482,294.78 in 1953; and $520,684.56 in 1954. The reason for the discrepancy between $8.75 and the amount which results from dividing the dollar volume by the tonnage is that the tonnage figure refers to clay mined rather than to bricks sold.

The taxpayer, in its returns, deducted 15 per cent of the gross income from sales of face brick for mineral depletion: $70,304.12 in 1951; $69,850.25 in 1952; $72,344.22 in 1953; and $78,102.68 in 1954. The Commissioner determined that the proper depletion allowances would create the following income tax deficiencies: $29,844.92 in 1951, $38,460.94 in 1952, $32,228.49 in 1953, and $40,748.37 in 1954.

[2] Three were sought jointly and one brought by each party individually. The purpose of these continuances was a continued attempt at settlement and a desire to await the decision of the Supreme Court in the *Cannelton* case which would have been dispositive of the question involved.

the ordinary *non-integrated* miner.[3] The depletion allowance, therefore, should be based on the value of the mineral at the point where the non-integrated miner disposes of it and not on the value of the finished product; the integrated manufacturer "but sell[s] to himself the crude mineral that he mines". As succinctly stated in the recent case of *Riddell v. Monolith Cement Co.*, 1962 371 U.S. 537, 538, 83 S. Ct. 378, 9 L. Ed. 2d 492, *reversing* 301 F. 2d 488, *Cannelton* held that "the statutory percentage depletion allowance should be cut off at the point where the mineral first became suitable for industrial use or consumption . . ., namely, 'where the ordinary miner shipped the product of his mine'."

Promptly after *Cannelton* was decided, the taxpayer amended its complaint. The amended complaint alleged, and the district court found, that there is a national market for shredded ball clay of like kind and grade to Henderson's clay at $10.50 a ton. Accordingly, the court held that the taxpayer was entitled to use the first method of constructing gross income, as set forth in Section 39.23(m)-1(e)(3) of Treasury Regulation 118. 199 F. Supp. 304. We reverse.

[3] Congress has effectively removed the first commercially marketable product test, now that it has been clarified by *Cannelton*. The Core Amendments of 1961 have particularized those treatment processes which are to be treated as part of the mining operation. Section 613(c)(4) reads in part, "The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent that they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under Section 611: . . . (G) in the case of clay . . . crushing, grinding, and separating the mineral from waste, but not including any subsequent process, . . .". 26 U.S.C.A. 613(c)(4)(G). Section 302(b) of P.L. 86-564, the Tax Rate Extension Act of 1960

I.

The disparity between the $8.75 price for Henderson's brick and the representative price of $10.50 for shredded ball clay, strange as it may seem, is explainable. There is substantial evidence in the record that in the relatively small national market for ceramic clay, as contrasted with the market for brick, the costs of advertising, management, and research, necessary to sell the clay, offset the higher price per ton it commands. One of the Government's own witnesses, the president of a clay mining company, and a forty-year veteran of the business, testified that the price obtainable for clay bears no necessary relation to its quality; rather, the price is determined by "management, salesmanship, promotion, and usability of the material and the dependability of the producer." Henderson's secretary-treasurer and the general manager testified that Henderson did not attempt to sell clay because, being a young company, it was not prepared to install the extra equipment, processing, research, and engineering departments required in order to sell ball clay. It is not an unfair inference that Henderson found it more profitable and easier to sell brick for a smaller gross income per ton than to incur the expenses and increase the business complications involved in merchandising the clay on a nation-wide scale against experienced competitors.

Over 90 per cent of ball clay sold in the United States is mined in four counties in Kentucky and Tennessee. Henderson's witnesses testified that the taxpayer's clay had properties substantially similar to

the Kentucky-Tennessee clays, that it was the equivalent in range and grade of qualities to the average clay from that area, and that it was extracted by mining techniques similar to those employed by the Kentucky-Tennessee miners. The Government's expert witnesses controverted some of this testimony. However, "all conflict between experts as to commercial identity of the product has repeatedly been held peculiarly a matter for the determination of the trier of fact." *Riddell v. California Portland Cement Co.*, 9 Cir. 1962, 297 F. 2d 345, 351. See also *Sartor v. Arkansas Natural Gas Corp.*, 1944, 321 U.S. 620, 621, 64 S. Ct. 724, 88 L. Ed. 967.

Recognizing the difficulty in attacking on appeal the district court's factual determination, the Government challenges the finding on the ground that the court erred in assuming or finding that all ball clays are of "like kind and grade"; that since Henderson's shredded clay was not mined nearly as selectively as the Kentucky-Tennessee clay, it could not possibly be of like kind and grade to the clay mined by the Kentucky-Tennessee producers.

We are unable to accept this argument. It is premised on too narrow a construction of the phrase, "like kind and grade." The regulation speaks of "like" rather than "the same" or "identical".

In *Alabama By-Products Corp. v. Patterson*, 5 Cir. 1958, 258 F. 2d 892, *cert. den'd* 1958, 358 U.S. 930, 79 S. Ct. 318, 3 L. Ed. 2d 303, the taxpayer, an integrated miner-manufacturer who would have gained a higher depletion allowance by using the proportionate profits

method of determining basis rather than the representative field price, made an argument very similar to that advanced by the Government here. The company contended,

> "that the phrase 'mineral product of like kind and grade' as used in Section 39.23(m)-1(e)(3) refers to mineral products with the same inherent attributes and characteristics as the depletable mineral in question. The taxpayer points to the many physical and chemical properties that distinguish kinds of coking coals. Coking coals differ as to volatile matter, ash content, carbon pickup, sulphur content, porosity, and phosphorous content. The taxpayer argues therefore that none of the coking coal sold was of a 'like kind and grade' to the taxpayer's." 258 F. 2d at 896-97.

In rejecting this argument, we held that

> " 'like kind' is a broad phrase contemplating the distinction between classes of property (for example, personal and real) no matter how dissimilar they may be in location, in attributes, and in capacities for profitable use. [Citations omitted.] The District Court held, and we agree, that all bituminous coals are of like kind, or of the same general property classification.
>
> "The phrase 'like grade,' as it is used here, has not been interpreted. There is no indication that a narrow interpretation of this phrase was intended. Section 39.23(m)-7 of the Regulations indicates that a liberal interpretation was contemplated:
>
> '(a). If the fair market value of the property at a specified date is to be determined for the

> purpose of ascertaining the basis for depletion and depreciation deductions, . . . [t]he value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of *similar* properties, . . .
>
> It is not unlikely that the term 'similar properties' contemplates a 'mineral product of like kind and grade.' The District Court concluded that all bituminous coals in the Alabama fields are of like grade if commercially suitable for use in the manufacture of coke generally, regardless of the taxpayer's particular needs. To go further and classify coking coals according to their myriad of actual uses would lead to an unworkable system of grading coal, since the requirements of coke users vary so greatly. There would never be, in the case of coking coal, a 'mineral product of like kind and grade'; we would have a phrase without meaning."

The *Alabama By-Products* holding was that minerals are of like kind and grade if they are substantially equivalent by commercial standards. Physical, chemical, or geological differences have importance only if they give rise to differences in commercial competition. See *Riddell v. California Portland Cement Co., supra, Ion a Limestone Co.*, 1957, 28 T.C. 884, and *Spencer Quarries, Inc.*, 1956, 27 T.C. 392. Moreover, the question is not whether the products were actually used for the same commercial purpose but rather

whether they *could* have been so used. Here, there is considerable expert testimony supporting the taxpayer's position. Although this Court, on the same facts, might not have reached the same conclusion as the district judge, on the record before us, we cannot say that it was clearly erroneous or that he applied an improper legal standard.

II.

The case is not over and settled in the taxpayer's favor with our affirmance of the trial court's holding on "like kind and grade."

The following comparative figures are significant:

	Actual gross income from the sale of brick	Hypothetical gross income based on sales price of shredded ball clay
1951	$468,694.11	$562,172.10
1952	465,668.33	543,436.95
1953	482,294.78	563,842.65
1954	520,684.56	581,570.85

The taxpayer argues that there is nothing either unusual or incongruous in holding that "gross income from property" may exceed the amount actually received, and that such a result is compelled by *United States v. Cannelton Sewer Pipe Co.* Certainly, *Cannelton* seems to hold that an integrated miner-manufacturer *must* use as his depletable base a hypothetical gross income based on the market price of the mineral sold by the ordinary miner. And, on principle, it is irrelevant whether, in a particular case, the *Cannelton* rule will give a higher base or a lower base than the

gross income from the finished product will yield. Any other method of computing its "gross income from mining", the argument runs, will give a preference to the non-integrated miner of shredded ball clay, and will reintroduce, in reverse, the tax discrimination between integrated and non-integrated miners against which the whole tenor of the *Cannelton* opinion is directed.

Tax law is law unto itself. There are no equities in tax law. And there is an area of permissible illogic in tax law. But when a taxpayer claims depletion on a fictitious gross income greatly in excess of its actual gross income, we find the claim highly indigestible. If Henderson's explanation for the higher price of Kentucky-Tennessee ball clay is correct, the taxpayer is seeking to deplete the costs of research, advertising and management it did not incur in selling something it did not sell. We ask, therefore, Did Congress intend this result? And does this result necessarily follow from *Cannelton?*

The *Cannelton* decision rests on two bases. First, after a careful scrutiny of the legislative history, the Court concluded that "Congress intended to grant miners a depletion allowance based on the constructive income from the raw mineral product, if marketable in that form, and not on the value of the finished product." 364 U.S. at 86. The purpose of such an allowance was "not to recompense for costs of recovery but for exhaustion of mineral assets alone." Allowing a miner-manufacturer depletion on his finished product would result in the rate being applied

to manufacturing costs, including the plant, machinery and facilities. Thus, in order to apply the depletion rate as nearly as possible to the income from the raw mineral itself, an integrated miner-manufacturer must take as the basis for his hypothetical gross income the market price of the product as sold by the ordinary miner. Second, permitting the use of the sales price of the finished product would give the integrated miner-manufacturer a tax preference and a resulting competitive advantage over the non-integrated miner. Thus, the Court said: "Congress never intended that depletion create such a discriminatory situation. As we see it, the miner-manufacturer is but selling to himself the crude mineral that he mines insofar as the depletion allowance is concerned." 364 U.S. at 87.

Neither of these bases supports the taxpayer's position and the first actively militates against it. If the purpose of *Cannelton* was to limit depletion as far as possible to the income from the marketable product closest to the raw mineral, there is no basis whatsoever for allowing the taxpayer to use the sum of $10.50 per ton as its base. This would take into account, not only Henderson's permissible costs of mining, but also unallowable costs of manufacturing. Further, it would take into account expenses such as for research and advertising, which non-integrated miners pay, because they are marketing the clay, but which Henderson never incurred. Clearly the proportionate-profits method, although yielding an equally hypothetical result, comes closer to ascertaining the taxpayer's gross income from its purely mining activities than Henderson's market-price method.

Moreover, when the Supreme Court eschewed a method of computing a depletion basis which discriminated against the ordinary miner, it had in mind, primarily, a situation in which the integrated and non-integrated miner were in competition with each other. Depletion computed on the finished product gave the integrated miner-manufacturer a competitive advantage because he found it more economical to integrate his operations, i.e., to mine his own mineral, than to buy the raw material from the non-integrated miner. Here, Henderson and the ceramic ball clay producers of the Kentucky-Tennessee area are in no sense in competition with each other. There is nothing in the record to indicate that if taxpayer had chosen to sell raw ball clay that it would have received $10.50 per ton, the similarities with the Kentucky-Tennessee clay notwithstanding. Perhaps, the most convincing evidence that Henderson was not potentially competitive was that it did not in fact compete. It passes belief that Henderson would buy clay for $10.50 per ton to make into brick selling for $8.75 per ton.

It is true, as *Mertens*, citing *Oliver Mining Co.*, 10 T.C. 908 and Rev. Rul. 6098 CB 1960-1, p. 252, points out, that "'gross income from the property' may exceed the amount *actually* received by the owner of the property." (Emphasis added.) 4 Mertens, Law of Federal Income Taxation §24.32b (1960 Rev.). Thus, for example,

> where an operating company, having sold control over the operation of mining properties, paid the owner of such properties a proportionate share after deducting all expenses and charges incident

> to the production and sale of the minerals, it was held that the gross income of the owner, for depletion purposes, was its proportionate part of the gross income of the properties rather than the smaller actual amount which was turned over to it by the operation company. 4 Mertens, Law of Federal Income Taxation §24.32b (1960 Rev.).

And again,

> where a mine operator sells his product through a del credere sales agent, the full selling price, unreduced by the sales commission, is the 'gross income from the property' for the purposes of the Code. 4 Mertens, Law of Federal Income Taxation §24.32b (1962 Cum. Supp.).

There is a real difference between a gross income in excess of the *income actually received* and a hypothetical gross income in excess of the *actual gross income*. In other words, in each of the above illustrations, the taxpayer's gross income was held to include the operating or selling expenses which had been deducted before the income was paid to the taxpayer. This is an entirely different situation from the case at bar. At no point was the taxpayer's actual gross income, unreduced by any expenses incurred in production and selling, $10.50 a ton of any product sold. *Cannelton* requires the computation of a hypothetical gross income for an integrated miner-manufacturer, but it does not require the computation of *this* kind of gross income. See *Helvering v. Mountain Producers Corp.*, 1938, 303 U.S. 376, 58 S. Ct. 623, 82 L. Ed. 907; *Grandview Mines v. Commissioner*, 9 Cir. 1960, 282 F. 2d 700; *Crews v. Commissioner*, 10

Cir. 1937, 89 F. 2d 412. In *Crews* the Court said:

> To allow a deduction on the basis of income never received and therefore no part of the gross income, on the net part of which a tax is extracted would be manifestly unfair. While oil extracted and sold to the Refining Company depleted the land, the depletion allowance is not granted to create a depletion reserve but to allow a deduction from gross income for tax purposes and there should not be included in such gross income proceeds of oil never received by the taxpayer and no part of which became subject to income taxation.

The Government directs us to *Roundup Coal Mining Co.*, 1953, 20 T.C. 388, where no depletion allowance was allowed for coal that was mined and used by the taxpayer to operate its coal mining facilities. The Government argues that this case supports its proposition: there is no actual gross income and hence there can be no constructive gross income. In that case the Tax Court rested its decision primarily on the fact that there was no sale of the coal in question. It is difficult to reconcile *Roundup Coal* with *Woodward Iron Co. v. Patterson*, N.D.Ala., 1959, 173 F. Supp. 251. In *Woodward Iron* the taxpayer, a manufacturer of pig iron, owned certain captive coal mines. The coal from these mines was almost exclusively used to make coke to be used in the manufacture of pig iron. Depletion allowance for the coal used in the manufacturing process was allowed and the comparative market approach was used. There was no more sale of the coal than there was in the *Roundup* case. Actual gross income from the coal was realized in only the

most remote and theoretical way (as part of the sale price of the finished pig iron). The *Woodward* and *Roundup* may be distinguished from each other; in *Roundup* the cost of the coal used in the mining operation is reflected in the selling price of the coal produced which is actually sold on the market. The taxpayer will get a depletion allowance based on all of the selling price of this coal whereas the sale of pig iron brings no such deduction.

Even if we accept the captive mine case as one where the manufacturer actually receives income which can be constructively attributed to the mining operation, the case before us shows many potential cost considerations that might cause a miner to reduce his gross income in order to enhance its net profits. On the other hand, were the price of the Kentucky-Tennessee ball clay $8.40 per ton (10c less than the price of finished brick) the result would be hardly less anomalous, especially in the light of the transportation differentials. Even though the *actual* gross income figure is conclusive when the crude mineral product is sold without further processing or transportation, *Helvering v. Mountain Producers Corp.*, we are forced to conclude that there is no particular magic about it in the context of constructive gross income and thus we can accept no iron-clad rule such as the Government proposes.

The competitive market approach is to be used only if there is a "representative market or field price" of an essentially similar product. The Regulation does not allow the indiscriminate use of any price of a

product of like kind and grade, but requires the price to be representative; "representative" should be interpreted to qualify the entire phrase "market or field price".

The task of giving specific meaning to the term "representative" in this context is an imposing one. The first source of aid is the allied field of oil and gas. The problem of depletion for the integrated driller-processor or driller-transporter raises the same definitional problems in the determination of gross income. The relevant sentence from Treasury Regulations 118, Section 39.23(m)-1(e)(1) is as follows: "If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation."

Oil and natural gas are relatively fungible. There is therefore no great difficulty in determining comparative products. Two cases have raised the difficult question of defining "representative market or field price": *Hugoton Production Co. v. United States*, Ct. Cl., 1963, 315 F. 2d 868 and *Shamrock Oil & Gas Corp.*, 1961, 35 T.C. 979. In the *Hugoton* case the problem in determining representative price was basically one of deciding whether to use the wellhead price, which was included in long term contracts entered into during the tax years in question, or, to use that price which was included in prior long term contracts under which the comparable gas was actually

sold during the tax years. The court chose the latter price. In doing so, the court determined the price the taxpayer would have received at the wellhead, if it had sold such gas. If the taxpayer would not have received that price, had the taxpayer chosen to sell at the wellhead, then that price would not be "representative". "Representative market or field price" is not a boiler plate and *Hugoton* gives us the basic approach with which to attack the question: "In any event, the prime question in defining representative market or field price must be the purpose for which such a price is calculated." 315 F. 2d 868 at 875. "While the act of Congress and regulations adopted in pursuance thereof must be construed according to their plain import, it should be borne in mind in determining the amount of the depletion allowance that such allowance is intended to represent the amount of capital recovered in the product produced by the well, that is the value of the raw product." *Brea Cannon Oil Co. v. Commissioner*, 9 Cir. 1935, 77 F. 2d 67 at 69.

In the light of this basic purpose, Regulation 39.23 (m)-1(e)(3) must be seen as a constructive means of estimating that part of the integrated producer's gross income which is attributable to the operation of mining, i.e., the depletion of a capital resource. It is thus a means of *disintegrating* an integrated company back into separate mining and processing entities. The proper gross income is that which the hypothetical mining entity would realize upon selling its products to its processing alterego. The need for this constructive disintegration is emphasized by the strong desire

to afford no unfair tax advantage to the integrated producer vis-a-vis the non-integrated miners and manufacturers. The representative price is then the competitive going price for the product, i.e., the price charged by the taxpayer's competitors.

Clearly the Kentucky-Tennessee ball clay price of $10.50 per ton is not representative insofar as its use does not fulfill the statutory objective outlined above. This price in no way represents the depletion of the taxpayer's clay resources and in no way represents the price which a non-integrated brick manufacturer would pay for clay with which to make brick.

Turning again to *Cannelton*, we observe that in *Cannelton* the question was one of identifying the first commercially marketable product so as to mark the end of the mining process for the purposes of Section 114(b)(4). The court held that commercial profitability was not relevant in defining the product which had passed sufficiently from its natural state so as to become marketable. The case was remanded to be treated according to Regulation 39.23(m)-1(e)(3); there is no indication that the proceedings in the Supreme Court have any bearing on this determination over and above the establishment of the "product" on which the depletion allowance is to be granted. Our conclusion, therefore, that the commercial realities demonstrate that the price of $10.50 a ton is not "representative" is consistent with *Cannelton*.

There is one final problem with the taxpayer's position. Henderson has suggested that it sells brick for $8.75 per ton instead of clay for $10.50 per ton be-

cause the research, advertising and marketing expenses involved in selling clay might well result in a lower net profit than that received from selling brick. If this is true, then it would be necessary for the taxpayer to compute *a hypothetical net income* corresponding to its proposed hypothetical gross income. Section 114(b)(4)(A) allows a depletion allowance only up to fifty per cent of the taxpayer's net income. Since fifteen per cent of $10.50 would obviously give a much higher allowance than fifteen per cent of $8.75, this, coupled with the lower net income which would have been received from the clay, might well have resulted in a depletion allowance in excess of the fifty per cent of net income permitted by the statute. *Cf.*, Comment, 28 U.Chi. L. Rev. 121, 128-129 (1960). What method would be used to determine such a hypothetical net income is far from clear. In short, the taxpayer's position would involve a highly complex interweaving of hypothetical incomes. We cannot believe that Congress, in enacting uniform depletion rates which had, as one of their cardinal virtues, simplicity of operation, ever intended the application of these rates to become bogged down in such complexities.

We hold, therefore, that this taxpayer must use the proportionate-profits method of computing depletion base, since that method comes closer to carrying out the intent of the depletion sections, as construed by the Supreme Court in *United States v. Cannelton Sewer Pipe Co.* than taking the "representative market or field price" for clay "of like kind and grade".

III.

Section 7422 of the 1954 Code provides that "no suit or proceeding shall be maintained . . . until a claim for refund of credit has been duly filed."[1] The regulations require that each claim must set forth in detail the grounds upon which the refund is sought.[2] The Government argues that Henderson's claims for refund were predicated solely on the contention that since its preprocessed shredded clay had no market value, the gross income from the sale of brick was its depletable basis. The second count of its amended complaint, on which it recovered, was added after the decision in *Cannelton*, and asserted that the depletable basis was the market price of clay in its shredded form. This count, according to the Government, takes a position diametrically opposite from that urged in the refund claims, and the taxpayer is thus precluded

[1] Section 7422. CIVIL ACTIONS FOR REFUND.

(a) No Suit Prior to Filing Claim for Refund.—

No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary or his delegate, according to the provisions of law in that regard and the regulations of the Secretary or his delegate established in pursuance thereof.

[2] Section 301.6402-2 Claims for credit or refund.—

(b) Grounds set forth in claim. No refund or credit will be allowed after the expiration of the statutory period of limitations applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof.

from recovering on it.[6]

This argument overlooks the purpose of these administrative regulations. Treasury Regulation 301.6402-2 itself states that "the claim must set forth in detail each ground upon which a credit or refund is claimed and facts *sufficient to apprise the Commissioner* of the exact basis thereof," (emphasis added); and, as we pointed out in *Carmack v. Scofield*, 5 Cir. 1953, 201 F. 2d 360, 361-62, "the principal requirement of the statute . . . and the regulations supplementary thereto, is that the Commissioner be apprised by the timely filing of a claim of the exact basis upon which the claim for a refund is predicated."

Henderson's claims for refund, filed shortly after it had paid the deficiency assessments stated that the depletion allowance permitted by the Revenue Agent was erroneous, that it was entitled to a fifteen per cent depletion rate on its gross income from mining ball clay; and that its first commercially marketable mineral product, which, according to §114(b)(4)(B), constitutes the depletable basis, was finished burnt brick. These claims were rejected on various dates between April 13, 1956, and November 13, 1957. On January 27, 1958, Henderson filed this suit, alleging that its depletable basis was the gross income from the sale of brick. After a conference, attorneys for

[6]Section 6511. LIMITATIONS OF CREDIT OR REFUND.

(a) Period of Limitation on Filing Claim — Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within three years from the time the return was required to be filed or 2 years from the time the tax was paid, whichever of such periods expired the later.

both parties agreed that the case should be settled, and a joint motion for a continuance was granted. The motion, filed July 3, 1958, stated in part:

> "That Plaintiff and Defendant have agreed on all issues of fact and the law of the case except as to one point, that point is as to whether or not ball clay has no substantial market value in the area of the Plaintiff's operation for other purposes other than the making of brick. Both Plaintiff and Defendant are making their investigation at this time as to such question, and it is the opinion of the attorneys of both Plaintiff and Defendant that said cause can be settled without the necessity of further litigation if said cause is concluded."

Another joint motion for continuance was granted on August 26, 1958.

On September 12, 1958, plaintiff's attorney wrote the Department of Justice offering to settle on the basis of the original complaint and pointing out the facts later to become the basis of the second count in the amended complaint: that taxpayer processed shredded ball clay which, on the national market, brought an average price of $10.50 per ton and that this price should be used in determining the depletion deduction. September 27, 1958, the Justice Department wrote acknowledging receipt of the letter and advising that it would obtain the views of the Chief Counsel of the Internal Revenue Service. In October the parties' attorneys discussed the facts set forth in the letter of September 12, 1958, and inquires were made at Henderson's plant about its clay.

Several more continuances were granted at the joint request of both parties, and on December 24, 1959, defendant requested another continuance pending the disposition by the Supreme Court of the *Cannelton* case. The Government indicated that the decision in that case would be dispositive of the issues involved in *Henderson*. The Supreme Court handed down its decision on June 27, 1960, and held that an integrated miner-manufacturer's depletable basis was not the gross sales price of the finished product, but the value of the mineral at the point where it was sold by the non-integrated miner. December 14, 1960, Henderson amended its complaint to include the grounds for refund set forth in its letter of September 12, 1958, and supported, in part at least, by *Cannelton*. The defendant did not object to this amendment and its answer, filed January 16, 1961, did not assert that the original claims for tax refund were not broad enough to include this second count. In fact, in February, 1961, an Internal Revenue agent again visited Henderson's plant and took samples of its clay, and in March the Government took the depositions of several non-integrated clay miners in the Kentucky-Tennessee area.

The District Judge found that the taxpayer set forth the factual basis for the second count of its amended complaint in its letter of September 12, 1958, and the Commissioner had knowledge of this alternative ground for refund and investigated it for two and a half years before the date of trial. *See United States v. Humble Oil and Refining Co.*, 5 Cir. 1934, 69 F. 2d 214, 217. On this record there is ample

support for the District Judge's finding that the Commissioner did in fact waive the provisions of Treas. Reg. 301.6402-2 requiring the facts upon which the complaint is based to be set forth in the claim for refund.

The taxpayer's second count, which is based on the facts set out in its letter of September 12, 1958, asserts no other ground for recovery than its original claims. Both are based upon §114(b)(4)(B), and the amended complaint merely takes account of a definitive construction of that subsection which was handed down between the date of the claims and the date of trial.

In *Hartley v. United States*, 5 Cir. 1958, 252 F. 2d 262, the taxpayer's refund claim, based on the theory that his rebuilt engines were not parts under the excise tax statute, stated

> "The tax is limited to the sale price of only the old used parts reworked, or machined, by taxpayer. The tax does not apply to subsequent sales by taxpayer, a purchaser of new automobile parts, purchase tax paid by him, from other manufacturers. The putting together by taxpayer of new automobile parts complete in themselves purchased taxpaid, with old parts machined by him, which are also complete within themselves, and on which he paid the tax, does not result in another and different taxable article."

In holding that the refund claim was broad enough to support a complaint based on the proposition that the taxpayer was not a "manufacturer" within the mean-

ing of the statute as well as one based on the ground that rebuilt engines were not "parts," this Court stated,

> "[W]e are of the clear opinion . . . that under the facts of this case, Burrell v. Fahs, 232 F. 2d 163 (5th Cir. 1956), and not Carmack v. Scofield, 201 F. 2d 360 (5th Cir. 1953) is controlling here, and that, therefore, the taxpayer's claim for refund comprehended, embraced, and included the issue tendered by taxpayer in his complaint and here, whether International's operations constituted manufacturing within the meaning of the applicable statute." 252 F. 2d at 265.

We hold that the trial judge did not err in refusing to dismiss the second count of Henderson's amended complaint.

The judgment is REVERSED and REMANDED.

Opinion of United States District Court (199 F. Supp. 304):

HENDERSON CLAY PRODUCTS, *Plaintiff*,

v.

UNITED STATES OF AMERICA, *Defendant*

Civ. A. No. 2463

United States District Court
E. D. Texas,
Tyler Division
Sept. 6, 1961

SHEEHY, Chief Judge.

Plaintiff instituted this suit on January 27, 1958, seeking a refund of income and excess profits taxes, together with interest thereon, assessed against it by the Commissioner of Internal Revenue, hereinafter referred to as Commissioner. The facts as admitted by the parties and as found by the Court as well as the contentions of the parties are as hereinafter stated.

Plaintiff is a Texas corporation, with its principal office in Henderson, Texas, within this district and division. It owns clay pits and deposits located near Henderson, Texas, and is engaged in the business of mining the clay from said clay pits and manufacturing said clay so mined into brick which it sells throughout the United States. Plaintiff keeps its books on a basis of a fiscal year ending March 31 and uses the accrual system of accounting.

Within the time prescribed by law it filed its income tax returns for the fiscal years ending March 31, 1951, 1952, 1953 and 1954 with the Commissioner. In such returns it took deductions for percentage depletion on the clay it mined from its pits and manufactured into brick. Thereafter such returns were examined by an agent of the Internal Revenue Department who adjusted the deductions for percentage clay depletion and found and determined deficiencies in income and excess profits taxes, which deficiencies, with accrued interest thereon, Plaintiff thereafter paid. The Commissioner found that Plaintiff's clay qualified as ball clay and allowed depletion at the statutory rates specified for ball clay by using the proportionate profits method of determining the gross income from mining provided for by Treasury Regulations 118, § 39.23(m)-1. The total tax paid by Plaintiff for the year ending March 31, 1951, was the sum of $81,612.73. The total tax and interest paid by Plaintiff for the year ending March 31, 1952, was the sum of $93,101.45. The total tax and interest paid by Plaintiff for the year ending March 31, 1953, was the sum of $58,897.68. The total tax and interest paid by Plaintiff for the year ending March 31, 1954, was the sum of $95,361.49. Thereafter Plaintiff filed claims for refunds of income taxes and excess profits taxes paid by it for said four years, said claims having been filed and having been rejected as follows: the claim for the fiscal year ending March 31, 1951, was filed on June 29, 1955, and rejected by the Commissioner on April 13, 1955; the claim for the fiscal year ending March 31, 1952, was filed on June 13, 1955, and was

rejected by the Commissioner on April 13, 1956; the claim for the fiscal year ending March 31, 1953, was filed on June 13, 1956, and was rejected by the Commissioner on April 1, 1957; the claim for the fiscal year ending March 31, 1954, was filed on June 14, 1957, and was rejected by the Commissioner on November 13, 1957.

Each of the claims for refund, referred to in the paragraph next above, (1) stated that Plaintiff was the owner of clay deposits from which the clay was taken and made into brick and that the clay was ball clay; (2) referred to and incorporated in such claim Plaintiff's income tax return for the year in question and the Internal Revenue Agent's report applicable to such return; (3) stated that Plaintiff claims that the depletion allowed by such Revenue Agent's report from the mining of ball clay was erroneous; (4) averred that Plaintiff was entitled to depletion on the clay extracted at the rate prescribed for ball clay (15%) as provided by § 114(b) (4) (A) (iii), I.R.C. 1939, 26 U.S.C.A. § 114(b) (4) (A) (iii); (5) stated that the depletion allowance allowed Plaintiff should have been based on the gross income from mining and quoted the § 114(b) (4) (B) definition of gross income from the property and from mining; (6) stated the first commercially marketable mineral product obtained from its mining of ball clay was finished burnt brick and that all processes requisite to producing the burnt brick were ordinary treatment processes of mining as defined by the Code; and (7) claimed a refund of income and excess profits taxes in specific amounts or such greater amounts as might be due

with interest thereon as provided by law. The explanation given in the Revenue Agent's reports recommending disallowance and rejection of such claims was that the Internal Revenue Agent had allowed the depletion computed on the proportionate profits method of determining the gross income from the property and that the Commissioner had not acquiesced in the computation of depletion on the sales price of brick.

In its original complaint the Plaintiff alleged and contended that it sold no clay at any stage prior to the finished brick product; that it had no commercial market for such clay prior to the time it was in the finished brick stage; that such finished burnt brick was Plaintiff's only commercially marketable mineral product; that no commercial market existed in the area of Plaintiff's clay pits for clay in the quantities mined by the Plaintiff other than in the finished burnt brick state; and that it was entitled to a depletion allowance of 15% of the gross income from the sale of its burnt brick not to exceed 50% of the net income from the sale of its brick. In June 1958 one of Plaintiff's attorneys discussed this case with the attorneys in the Department of Justice who were in charge of the case and agreed that the case should be settled. Following that discussion and at a time when this case was set for trial for July 14, 1958, the parties hereto filed on July 3, 1958, a joint motion for continuance. Among other statements made in said motion were the following:

> "That Plaintiff and Defendant have agreed on all issues of fact and the law of the case except as to one point, and that point is as to whether

or not ball clay has any substantial market value in the area of the Plaintiff's operation for other purposes other than the making of brick. That both Plaintiff and Defendant are making their investigation at this time as to such question, and it is the opinion of the Attorneys, both Plaintiff and Defendant, that said cause can be settled without the necessity of further litigation if said cause is continued."

That motion was granted on July 7, 1958. Thereafter the case was reset for trial for September 2, 1958. On August 25, 1958, the parties filed another joint motion for continuance requesting that the case be removed from the settings for September 2, 1958, in order that the parties might be given a further opportunity to settle the case. That motion was granted on August 26, 1958.

By letter dated September 12, 1958, Plaintiff's attorney submitted to the Justice Department its offer of settlement which was that Defendant make refunds to the Plaintiff in the amounts claimed in the original complaint. In said letter the Plaintiff, after pointing out the fact that ball clay substantially the same as Plaintiff's ball clay was at the stage it was ready for Plaintiff's pug mill was during the tax years in question mined in the Tennessee-Kentucky area and sold after undergoing processes substantially the same as used by Plaintiff up to the point its clay was ready for the pug mill, as shredded clay or air-floated clay and that there was a national market for such shredded and air-floated ball clay, stated:

"Consequently, if it be said that on the national

market Henderson's first commercially marketable mineral product was unprocessed ball clay, it would follow that the prevailing prices for such clay should be used in determining Henderson's depletion deductions; if so, Henderson would be entitled to greater depletion deductions than it now claims—without regard to whether the average prices ($15.50 per ton) resulting from our investigation or the Year Book averages ($10.80 to $12.70) be used."

By letter dated September 27, 1958, addressed to Plaintiff's attorney, the Justice Department acknowledged receipt of Plaintiff's attorney's letter of September 12, 1958, and advised that the Justice Department would obtain the views of the Chief Counsel, Internal Revenue Service, and final action would be taken by or on behalf of the Attorney General.

In October 1958, pursuant to an agreement between the Justice Department and Plaintiff's attorney, an Internal Revenue agent discussed with Plaintiff's counsel the facts stated in Plaintiff's attorney's letter of September 12, 1958, and went to Plaintiff's plant and made inquiry about Plaintiff's clay and made further investigation. Sometime prior to April 16, 1959, this case was again set for trial for May 4, 1959. In a letter dated April 16, 1959, addressed to Plaintiff's attorney, the Justice Department stated, among other things, as follows:

> "We have just recently received the results of a supplemental investigation conducted by the Internal Revenue Service and final action with respect to your offer by or on behalf of the Attorney General has not been taken.

"Accordingly, we would appreciate having this case continued generally pending a consideration of your offer by this office. A copy of this letter is being sent to the United States Attorney."

On April 22, 1959, the Defendant filed a motion asking that this cause be again continued because an offer of compromise was then under consideration and attached thereto a letter dated April 17, 1959, written by Plaintiff's attorney to the United States Attorney for this district wherein Plaintiff's attorney, in effect, agreed to a continuance of the case in order that further consideration could be given to Plaintiff's offer of settlement. The last mentioned motion for continuance was granted on April 23, 1959. Thereafter and sometime prior to August 14, 1959, the case was reset for trial for October 12, 1959. On August 14, 1959, Plaintiff's attorney addressed a letter to the Department of Justice requesting that he be advised as to Plaintiff's offer of settlement made in his letter of September 12, 1958. On September 15, 1959, the parties filed another joint motion for continuance stating in said motion that it was believed that if additional time were given, the parties would possibly settle the case. That motion for continuance was granted September 16, 1959. Thereafter the case was again set for trial for January 18, 1960. On December 24, 1959, the Defendant filed another motion for continuance of this cause, and that motion stated in part as follows:

"1. On December 14, 1959, the Supreme Court granted the Government's petition for certiorari in United States v. Cannelton Sewer Pipe Co.

(S.D.Ind.) decided June 25, 1958, (2 A.F.T.R.2d 5277), affirmed, 268 F.2d 334 (C.A. 7th), which case involves issues substantially identical to the issues in this case; that is, what is the first commercially marketable mineral product of a particular mineral deposit within the meaning of the applicable statute.

"2. A decision by the Supreme Court in the Cannelton case in all likelihood would be dispositive of the same issues involved in this case."

That motion was granted on December 30, 1959. On January 2, 1960, the Plaintiff filed a motion to set aside the order granting Defendant's last mentioned motion for continuance. A hearing was had on said motion, and on January 8, 1960, said motion was denied. No further settings of the case for trial were made until subsequent to the decision of the Supreme Court in United States v. Cannelton Sewer Pipe Co., 364 U.S. 76, 80 S.Ct. 1581, 4 L.Ed. 2d 1581. In the decision handed down on June 27, 1960, the court in that case held that the depletion allowance granted by the Revenue Code to miners for certain minerals, including clay, was to be based on a constructive income from the mineral, i.e., the value of the mineral at the point where ordinary non-integrated miners disposed of their product and not on the value of the finished article manufactured from said minerals. On December 7, 1960, the Plaintiff filed a motion for leave to file an amendment to its original complaint and stated in said motion that in view of the decision of the Supreme Court in the Cannelton case, supra, Plaintiff desired to add a count to its complaint alleg-

ing the facts which under the Cannelton case Plaintiff believed required a judgment in its favor. The proposed complaint was in two counts. Count A was an adoption of the original complaint. In Count B, the added count, Plaintiff alleged, in effect, that during the tax years in question there was a market for shredded and airfloated ball clay identical with or substantially the same as its ball clay, and that said market averaged $10.50 per ton for shredded clay and $20.50 per ton for air-floated clay; that the shredded and or air-floated ball clay was the first commercially marketable mineral product obtained by the ordinary treatment processes applied by mine owners to ball clay; that in the process of mining its clay and manufacturing brick it, by the use of the ordinary treatment processes normally applied by mine owners in order to obtain shredded clay and or air-floated clay, produced shredded ball clay; and that because of such facts, it, if it were not entitled to recover on the basis set forth in Count A of its complaint, was entitled to a refund of income and excess profits taxes determined by using as its depletion allowance 15% of the product of the number of tons produced by it times the value of the shredded ball clay and or air-floated clay. The Defendant made no objection to the filing of said amendment to the complaint. An order was entered on December 20, 1960, granting Plaintiff leave to file said amended complaint and on that date said amendment was filed. On January 16, 1961, Plaintiff filed its amended answer in answer to Plaintiff's amended complaint but did not allege as an affirmative defense or otherwise that the

basis for Plaintiff's claim for refund as set forth in Count B of its amended complaint did not come within the scope of the claims for tax refunds that the Plaintiff filed with the Commissioner.

In February 1961 an employee of the Internal Revenue Service again visited Plaintiff's plant, observed Plaintiff's mining and manufacturing operations, took samples of Plaintiff's clay and discussed with Plaintiff's representatives Plaintiff's mining and manufacturing processes, etc. During the latter part of March 1961 and after this case had been set for trial for April 4, 1961, Defendant, pursuant to notice of intention to take depositions previously filed on March 17, 1961, took the depositions, by oral examination, of five ball clay miners in the Tennessee-Kentucky area where substantial quantities of ball clay are mined and developed from said witnesses facts relating to the character of ball clay mined, the methods of mining and treatment processes normally applied by such miners, the commercially marketable mineral products of said ball clay and the prices received by such miners for ball clay during the tax years in question. Each of said depositions was offered in evidence at the trial.

This case was called for trial on April 4, 1961. After both the Plaintiff and Defendant announced ready for trial, the Defendant, without previous notice to either the Court or to the Plaintiff, filed and presented its motion to dismiss Count B of the amended complaint on the ground that the basis for recovery set forth in said Count B did not come within the scope of the claims filed by Plaintiff with the Commissioner. This was the first time that the Defendant had made

such an assertion or contention. The Court reserved action on said motion to dismiss and carried it along with the case. Although the factual basis for Count B was set forth, in effect, in Plaintiff's offer of settlement contained in its letter of September 12, 1958, above referred to, and the Commissioner had such facts before him and investigated them for some two and one-half years prior to April 4, 1961, the date the case went to trial, the record fails to show that the Commissioner ever formally rejected Plaintiff's offer of settlement. However, it must be assumed that the Commissioner acted upon said offer of settlement and decided not to accept said offer sometime prior to Defendant announcing ready for trial even though such decision on the part of the Commissioner was not communicated to Plaintiff.

Section 23 of the Internal Revenue Code of 1939, 26 U.S.C.A. § 23 provides for a deduction from gross income of a depletion allowance on minerals. Section 114(b) (4) (A) authorizes a depletion allowance in the case of ball clay at 15% of the gross income from the property and provides such depletion allowance shall not exceed 50% of the net income of the taxpayer from the property. Section 114(b) (4) (B) defines "gross income from the property" as the "gross income from mining" and "mining" is defined to include not only extraction of a mineral from the ground but also "the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral * * * products, and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of

extraction from the ground to the plants or mills in which the ordinary * * * processes are applied thereto." This section further provides that "ordinary treatment processes" in the case of ball clay shall include "sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment." When the identity of the depletable product—the commercially marketable mineral product—is determined, the next step is to compute the taxpayer's "gross income" from that product. The Treasury Regulations have long made provisions for certain methods to be used in making that computation. Treasury Regulation 118, Section 39.23(m)-1 provides in part as follows:

> "(3) If the taxpayer sells the crude mineral product of the property in the immediate vicinity of the mine, 'gross income from the property' means the amount for which such product was sold, but, if the product is transported or processed (other than by the ordinary treatment processes described below) before sale, 'gross income from the property' means the representative market or field price (as of the date of sale) of a mineral product of like kind and grade as beneficiated by the ordinary treatment processes actually applied before transportation of such product (other than transportation treated, for the taxable year, as mining). If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes (or, if the product in its crude mineral state is merely transported, the price for which sold) minus the costs and pro-

portionate profits attributable to the transportation (other than transportation treated, for the taxable year, as mining) and the processes beyond the ordinary treatment processes."

The method to be used in computing "gross income from the property" when there is no representative or field price for the mineral product, as provided for by the regulation just quoted, is commonly referred to as the "proportionate profits method." Such method is a computation by which the sales price (covering both costs and profit) of what the taxpayer actually is allocated to mining (the depletable form of the mineral), and separated from manufacturing and other specialized operations, in proportion to the costs attributable to mining.

During the tax years in question Plaintiff was an integrated miner-manufacturer. It owned clay deposits which it mined and manufactured into brick which it sold on the market throughout the United States. It did not sell any of its clay except in the form of bricks. The clay it mined and manufactured into bricks was ball clay. During the tax years in question it mined and made into brick which it sold the following amounts of its ball clay: for the year ending March 31, 1951—53,540.2 tons; for the year ending March 31, 1952—51,755.9 tons; for the year ending March 31, 1953—53,699.3 tons; and for the year ending March 31, 1954—55,387.7 tons.

In mining its clay Plaintiff used the strip mining method. It removed the overburden down to the clay. The clay was then removed by the use of a dragline

and loaded into trucks which transported the clay approximately four miles to Plaintiff's plant. As removed from the pit or mine by the dragline, the clay was in large balls or lumps weighing up to 200 pounds. Upon the clay reaching Plaintiff's plant, Plaintiff by the use of a shredder or some other method disintegrated or shredded the clay down to a small manageable size. Upon that being done, the clay was either placed in Plaintiff's pug mill or stored for later use in the pug mill. When the clay was put into the pug mill, certain blending and screening was done and water was added so that it was reduced to malleable form and formed into the shape of brick. From the pug mill the clay in the shape of brick went to dryers, and from the dryers it went to the kiln for burning and oxidation. The clay came out of the kiln in the form of finished brick and was either loaded for shipment or stored for later shipment.

[1] Approximately 90% of the ball clay mined in the United States is mined in the Tennessee-Kentucky area. During the tax years in question there were a number of persons or firms engaged as non-integrated miners in the mining and selling of ball clay in that area. Like the Plaintiff, those miners used the strip mining method. They first removed the overburden from the ball clay deposit. The ball clay was then removed in large balls or lumps by the use of a dragline or a similar method and loaded into trucks which transported the clay to the mine operator's plant. Upon reaching the plant, the clay was disintegrated by the use of machinery to a small size—about the size of a walnut—which is commonly referred to as

shredded clay. The shredded clay was then either loaded for shipment or stored for later sale and shipment or further reduced to a pulverized—almost powder—size. The clay reduced to the pulverized size was commonly referred to as air-floated clay. The clay miners of the Tennessee-Kentucky area sold shredded ball clay and air-floated ball clay all over the United States. During the tax years in question there was a market for shredded ball clay and air-floated clay all over the United States, and the average market value of shredded ball clay during each of those years was the sum of $10.50 per ton. Therefore, I find that the first commercially marketable product obtained from ball clay is shredded ball clay, and that the processes applied by the miners of ball clay in the Tennessee-Kentucky area to obtain said shredded ball clay are those that must be normally applied by mine owners or operators in order to obtain shredded ball clay. The processes used by Plaintiff in mining and handling its ball clay up to the time said clay is put in its pug mill are substantially the same as the processes applied by ball clay miners in the Tennessee-Kentucky area in obtaining shredded ball clay. Plaintiff's ball clay in the condition it was in at the time it was put in Plaintiff's pug mill was the same or substantially the same as the shredded ball clay marketed by the ball clay miners in the Tennessee-Kentucky area. Thus I find and conclude that the first commercially marketable product Plaintiff obtained in the mining of its ball clay was its clay in the condition it was in at the time it was ready to be placed in Plaintiff's pug mill, i.e., shredded ball clay, and that the processes used by

Plaintiff in obtaining said shredded ball clay were the ordinary treatment processes normally applied by owners or operators of ball clay mines in order to obtain shredded ball clay. I further find that during each of the years in question Plaintiff's ball clay in the condition it was in at the time it was placed in Plaintiff's pug mill had an average market value or value of $10.50 per ton.

As above indicated, when the Commissioner examined Plaintiff's tax returns for the years in question, he used the proportionate profits method to determine the depletion allowance Plaintiff was entitled to for its clay and adjusted such depletion allowances so as to allow for depletion the sum of $22,395.61 for the year ending March 31, 1951; the sum of $21,349.50 for the year ending March 31, 1952; the sum of $15,440.80 for the year ending March 31, 1953; and the sum of $20,798.19 for the year ending March 31, 1954. The Commissioner's action in allowing depletion in only those amounts resulted in the deficiencies being assessed against the Plaintiff as hereinabove referred to. In applying such method the Commissioner determined that Plaintiff's mineral product was its clay at the point it was ready to go into Plaintiff's pug mill and all processes applied by the Plaintiff thereafter were manufacturing processes and were not ordinary treatment processes normally applied by mine owners or operators. It must be presumed that the Commissioner found that there was no market for Plaintiff's clay at the stage it was ready to go into Plaintiff's pug mill because the Treasury Regulation permitting use of the proportionate profits method,

above referred to, permits the use of such method only when there is no market for the mineral product.[1]

The Plaintiff asserts that the Commissioner was in error in finding that there was no market for its mineral product, and that the Commissioner was in error in using the proportionate profits method. In this connection the Plaintiff contends (1) that the first commercially marketable product obtained by it from its ball clay was the finished brick and that under the holdings in such cases as *United States v. Cherokee Brick and Tile Co.* (5th Cir.) 218 F. 2d 424 and *United States v. Merry Brothers Brick and Tile Co.* (5th Cir.) 242 F. 2d 708, its gross income from the property for depletion purposes or its depletion base was the sales price of its brick or (2) that if there were a market for its clay at the stage where said clay was ready to go into Plaintiff's pug mill, its gross income from the property or its depletion base for the purposes of depletion, under the holding in the Cannelton case, supra, should be the value per ton of said clay at the stage it was ready to go into Plaintiff's pug mill times the number of tons of such clay mined and processed during the tax year. A depletion base which is the product of the number of tons of ball clay mined and processed during the tax year in question times the value per ton for said clay at the point it was ready to go into Plaintiff's pug mill, i.e., shredded clay, would be somewhat greater than a depletion base for each of the years in question that was based on the sales price of Plaintiff's brick during the tax year.

[1] *Alabama By-Products Corp. v. Patterson* (5th Cir.) 258 F. 2d 892, 900.

[2] Under the findings above made to the effect that Plaintiff's first commercially marketable product obtained in the mining of its ball clay was shredded ball clay, i.e., clay in the condition it was in at the time it was ready to be placed in Plaintiff's pug mill; that Plaintiff's said shredded ball clay had a value of $10.50 per ton during each of the years in question and that the processes used in obtaining said shredded ball clay were the ordinary treatment processes normally applied by owners or operators of ball clay mines in order to obtain shredded ball clay, and, under the teachings of Cannelton, the sales price of Plaintiff's brick during the tax year was not its depletion base. However, under such findings and the teachings of Cannelton, Plaintiff's depletion base or gross income from its property during each of the tax years in question was the product of the number of tons of ball clay mined and processed by Plaintiff during the tax year times the value per ton ($10.50) of said clay at the stage it was ready to be placed in Plaintiff's pug mill.

Applying the 15% statutory depletion allowance for ball clay to the product of the number of tons of ball clay mined and processed by Plaintiff during each of the tax years in question, as above found, times $10.50, it follows that Plaintiff was entitled to depletion allowance for each of the tax years in question as follows: for the year ending March 31, 1951, the sum of $84,325.82; for the year ending March 31, 1952, the sum of $81,515.54; for the year ending March 31, 1953, the sum of $84,576.40; and for the year ending March 31, 1954, the sum of $87,235.63.

In each instance the depletion allowance just mentioned was less than 50% of the net income of the Plaintiff from its property for the tax year. Therefore Plaintiff is entitled to recover from Defendant the difference in the amount of taxes Plaintiff paid for each of the years in question and the amount those taxes would have been had Plaintiff been allowed for each of said years the depletion allowance it was entitled to as just found, with interest as provided by law on the overpayments of taxes made by Plaintiff, unless Defendant's contention made in its motion to dismiss Count B of Plaintiff's amended complaint is correct.

Section 7422 of the Internal Revenue Code of 1954, 26 U.S.C.A. § 7422 provides, in effect, that no suit shall be maintained for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected until a claim for refund has been filed with the Secretary of the Treasury or his delegate, according to the provisions of law in that respect, and the regulations of the Secretary of the Treasury or his delegate established in pursuance thereof.[2] The pertinent Treasury regulation provides that a claim for a tax refund must be made on Form 843 and further provides that the claim must set forth in detail each ground upon which the refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof.[3] Defendant, in its motion to dismiss Count B of Plaintiff's amended complaint,

[2]Section 3772 of the Internal Revenue Code of 1939, 26 U.S.C.A. § 3772 made like provisions.

[3]Treasury Regulations 301.6402-2.

contends that the grounds set forth by Plaintiff in said count were not asserted in its claim for refund filed with the Commissioner as required by the statute and regulation, above referred to, and because said grounds were not asserted in the claims filed before the Commissioner said grounds cannot be asserted as a basis for a recovery in this action.

[3, 4] It is well established that the timely filing of a claim for refund with the Commissioner is a statutory prerequisite to recover taxes alleged to have been illegally assessed and collected. *United States v. Felt & Tarrant Co.*, 283 U.S. 269, 51 S.Ct. 376, 75 L.Ed. 1025; *Carmack v. Scofield* (5th Cir.) 201 F. 2d 360; and *Snead v. Elmore* (5th Cir.) 59 F. 2d 312. The authorities just cited likewise stand for the proposition that, under a regulation requiring that a claim set forth each ground upon which the refund is claimed, a taxpayer cannot in its claim filed with the Commissioner assert one ground and in a suit to recover for taxes allegedly illegally assessed assert an entirely different ground. However, the Commissioner can waive the requirements of the regulation requiring that each ground relied upon by the taxpayer be asserted in the claim filed with the Commissioner and thus permit a taxpayer to assert in a suit to recover taxes a ground that he did not assert in his claim filed with the Commissioner. *Angelus Milling Co. v. Commissioner*, 325 U.S. 293, 65 S.Ct. 1162, 89 L.Ed. 1619; *Tucker v. Alexander*, 275 U.S. 228, 48 S.Ct. 45, 72 L.Ed. 253; *Sunland Industries v. United States* (9th Cir.) 248 F. 2d 768; and *Samara v. United States* (2d Cir.) 129 F. 2d 594 (Writ of Certiorari denied, 317

U.S. 686, 63 S.Ct. 258, 87 L.Ed. 549). As stated by the Supreme Court in the Angelus Milling Company case, supra, "Even tax administration does not as a matter of principle preclude considerations of fairness." [325 U.S. 293, 65 S.Ct. 1165.]

[5] After a careful consideration of Plaintiff's claims for refund filed with the Commissioner, I find and conclude that said claims comprehended, embraced and included the issues tendered by Count B of its amended complaint. Even if it should be determined that the issues tendered by Count B of the amended complaint were not embraced and included in the claims for refund filed by the Plaintiff, I find and conclude that the Commissioner, under the facts in this case as above found, waived the provisions of the regulation requiring the assertion of the grounds forming the basis of Count B in the claims for refund. Therefore, Defendant's motion to dismiss Count B of Plaintiff's complaint is without merit and will be overruled.

During the trial the parties agreed that if the Court concluded that the Plaintiff was entitled to recover and determined the depletion allowance that Plaintiff was entitled to for each of the tax years in question, the parties, upon being apprised of such conclusion and determination, would attempt to stipulate the amount of the recovery Plaintiff is entitled to without admitting the correctness of the Court's conclusions and determinations as to the amount of depletion the Plaintiff is entitled to for each of the tax years in question. In view of that agreement, the par-

ties will be given thirty days from the date of this Memorandum Decision within which to prepare and file as a part of the record in this case a stipulation as to the amount Plaintiff is entitled to recover in light of the findings and conclusions herein made. Upon such a stipulation being filed, the attorneys for the Plaintiff should present an appropriate form of judgment allowing Plaintiff a recovery in the amount set forth in the stipulation. In the event the parties are unable to reach an agreement as to the amount of recovery Plaintiff is entitled to within the thirty-day period, the Court, upon being so advised by the parties, or either of them, will order a hearing for the purpose of determining the amount of the recovery.

As authorized by Rule 52, F.R.Civ.P., 28 U.S.C.A., this Memorandum Decision, together with the stipulation, if any, made by the parties and filed herein as to the amount of recovery Plaintiff is entitled to under the findings and conclusions herein made or in the absence of such a stipulation the findings made by the Court, after hearing, as to the amount Plaintiff is entitled to recover, will constitute the Findings of Fact and Conclusions of Law herein.

Judgment of Court of Appeals:

No. 19471
D. C. Docket No. 2463 Civil

UNITED STATES OF AMERICA, *Appellant*,

versus

HENDERSON CLAY PRODUCTS, *Appellee*,

Appeal from the United States District Court for the Eastern District of Texas.

Before TUTTLE, Chief Judge, WISDOM, and GEWIN, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed and that this cause be, and it is hereby remanded to the said District Court in accordance with the opinion of this Court.

October 25, 1963

Order Denying Petition for Rehearing:

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 19471

UNITED STATES OF AMERICA, *Appellant*,
v.
HENDERSON CLAY PRODUCTS, *Appellee*.

Appeal from the United States District Court for the Eastern District of Texas.

(December 30, 1963)

ON PETITION FOR REHEARING

Before TUTTLE, Chief Judge, WISDOM, and GEWIN, Circuit Judges.

PER CURIAM:

It is ORDERED that the petition for rehearing filed in the above entitled and numbered cause is hereby DENIED.